

# Military Exchange Unification: Thinking About Future Governance

SECOND IN A SERIES

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## PREFACE

Dramatic corporate governance failures have captured national attention, resulting in new laws and regulations that have increased board responsibilities and accountability in publicly held companies. Some governance failures were criminal in nature; however, many were attributed to board competency shortcomings and the limited time directors applied to their stewardship role. An integrated Exchange system is a complex \$10 billion global business with special stewardship responsibilities for our soldiers, sailors, airmen, marines and retirees. If included in the Fortune 500, the system would rank 177. Though not bound by governance rules for publicly held corporations, an integrated Exchange system might usefully draw from today's best corporate governance practices. Governance should meet the highest standards of stewardship and expertise.

## GOVERNANCE OVERVIEW

This article examines problems of governance in publicly held companies, identifies best governance practices, and employs many of those best practices to suggest one model for governance of an integrated Exchange system.

The most contentious part of the model is likely to be inclusion of independent directors on the Board as is now required for public corporations by Sarbanes-Oxley, the SEC, and the NYSE, and recommended by many academic contributors to the subject of governance. Of particular interest and possible concern to future directors is the expectation that proper discharge of best practice responsibilities could exceed 150 hours per year and perhaps more.

The governance model in this paper presents the author's views and is expected to stimulate a vigorous debate as organizational and political interests are engaged.

## Governance Problems

In the preface to the book, *Boardroom Excellence*, Senator Paul S. Sarbanes notes that Paul P. Brontas "has written a superlative analysis of the crisis in corporate governance that has undermined the integrity of our markets (and) proved devastating to millions of investors and workers." <sup>1</sup> Brontas notes that too many of our publicly traded corporations were governed by corporate boards whose directors (among other failures):

- ◆ Lacked independence; were not committed and properly prepared.
- ◆ Failed to coordinate and contribute to the preparation of meeting agendas; did not spend enough time at board meetings and committee meetings; and never fully understood their duties.
- ◆ Failed to critically review the CEO's as well as senior executives' performance.

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♦ Were not aware of, or did not understand, the corporate financial statements.

He offers other governance weaknesses contributing to complacent and uninformed boards.<sup>2</sup> Time, knowledge and commitment are suggested as the ingredients of proper governance and excellence in the boardroom.

A Boston Consulting Group/Harvard Business School (BCG/HBS) 2001 survey of 132 CEOs noted that only 46 percent of non-executive North American board members understood the factors that drive performance in each of the main businesses. Carter and Lorsch add that too often directors fail to focus on the critical issues, are insufficiently prepared, or cannot recall what happened at the last meeting.<sup>3</sup>

The problem, according to Carter and Lorsch, is compounded by adding "boiler plate issues" to the board meetings intended, in part, to deflect discussion from core strategic issues. Meetings are infrequent and poorly planned with management attendees, who may have input, swelling the boardroom. Information provided to the board is substantial, but often not well organized nor summarized. Discussions of the financial past are common, but too little is about competitive performance, customer reactions, the implementation of major systems, employee morale, and the strengths of up-and-coming managers. CEOs claim they provide the information. In reality, it is buried in thick briefing books.<sup>4</sup> Carter and Lorsch quote a director as describing board meetings as death by Power Point.

Kaen notes that "A common criticism of U.S. Boards is that members hold positions on so many boards that they can't possibly devote the time and attention necessary."<sup>5</sup> Carter and Lorsch provide documentation of boards made up

of very competent people who are simply unable or unwilling to discharge their responsibilities to the board, who do not set and monitor performance objectives of the CEO and who are technically unable to participate effectively in key strategic choices. Moreover, they observe that an unspoken conspiracy can emerge wherein the board is shielded willingly from key problems, and the CEO is thus shielded from addressing the strategic imperatives of the business, particularly those involving significant change.

Time, attention and business understanding are the ingredients of a competent governance system. Complexity in these environments has grown significantly with competitive changes in technology. Not so long ago technology was a tool. Now new technologies are themselves creating important mass merchandising competitive strategic choices, threats, and opportunities. Carter and Lorsch add, "What really counts is the dedication, energy, time commitment, skills of the directors, the quality of their information, the leadership of board discussions, and the level of openness, transparency, and trust in the relationship among the directors and top management."<sup>6</sup>

A strong board cannot weaken the power of the CEO to lead management, but the relationship between the CEO and a strong board could be conflictual if the board has the power to recommend removal of the CEO for performance reasons. Carter, Lorsch and Kaen stress the importance of the board's structural design and precise definition of the board's role and the role of its subcommittees. All three authors note the importance of an internal process wherein board discussions, not presentations, are the norm, and the focus is on key issues important to the future health of the business. That internal process should be driven by an agenda determined by the

Chairman of the Board and/or the lead independent director.

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## **Visionary Exchange Governance**

As the Exchange system adopts a centralized structure, change will encounter human, technical and boundary control resistance. Major strategic choices will emerge regarding system-wide centralized practices and decentralized patterns of operations and supporting systems, all designed to grow MWR dividends and capital reserves while maintaining low prices. The unique requirements of the integrated Exchange system to run a \$10 billion enterprise, maintain low competitive prices, mount expeditionary Exchange support, accept some nonprofit outlets, meet Service-specific concerns, and support MWR dividends must, among other requirements, be incorporated into corporate strategy development. Moreover, all these demands are taking place in an environment of changing basing structure, intense competitive pressures and unfavorable demographic trends.<sup>7</sup>

Integrated Exchange governance leadership will require visionary business practices, political insights, technical business skills, financial knowledge, insight into the relative competitive environment, and the personal time to exercise strategic oversight of this complex and unique business. While not required, governance of this \$10 billion enterprise should take into account best board practices to include relevant principles from Sarbanes-Oxley. A world class integrated Exchange system has the opportunity to establish a model for the governance of a business enterprise within a government structure.

## IMPLICATIONS OF SARBANES-OXLEY

While not legally applicable to an integrated Exchange system, the Sarbanes-Oxley Act does put into law certain requirements that must be observed by publicly held corporate boards. Provisions of interest are:

- ◆ It shall be unlawful for a registered public accounting firm to provide any non-audit services to an issuer. (Section 201)
- ◆ Each member of the audit committee should be a member of the board of directors of the issuer and shall otherwise be independent. (Section 301)
- ◆ Independent is defined as not receiving, other than for service on the board, any consulting, advisory or other compensatory fee from the issuer and as not being an affiliated person of the issuer or any subsidiary thereof. (Section 301)
- ◆ The CEO and CFO of each issuer shall prepare a statement to accompany the audit report to certify the "appropriateness of the financial

statements and disclosures contained in the periodic report, and those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer. (Section 302)

- ◆ The annual report of an issuer is required to contain an "internal control report" which shall:
  - state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
  - contain an assessment as of the end of the issuer's fiscal year of the effectiveness of the internal control structure and procedures for financial reporting. The Act does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees. (Section 404)<sup>8</sup>

All of these provisions would be expected to be incorporated into best governance practices.

- Approval of the strategy as developed by management and an assessment of its effectiveness. (Note: For an integrated Exchange, add "in the context of the relevant demographic and competitive environment and unique Service-specific requirements.")
- Evaluation of the performance of the CEO (Commander) and his/her tenure.
- Oversight of the management development and succession planning.
- Evaluation of the Board's own process.<sup>9</sup>

To this list of best practices I would add:

- ◆ Ensure consistency, accuracy, and completeness of financial policy, financial performance comparison data, and financial integrity.
- ◆ Establish criteria for MWR dividends and the reserve for capital improvement.

### Board Time Commitment

Best practices demand an active and informed board. Membership involves a significant time commitment, and is particularly true of an organization the size of an integrated Exchange system with the complexity that integration will bring during its implementation. A Spencer Stuart's 2002 survey places the U.S. board average at 7.5 meetings per year.<sup>10</sup> Certain subcommittees meet even more often, and additional time is required for meeting preparation and, at times, one-on-one exchanges with key management members. Kaen suggests to do the job properly a rule of thumb is to devote at least 100 hours annually, although in recent years more hours have probably been devoted to the job.<sup>11</sup> Brontas believes that the average time devoted to board meetings of a large corporation (including non-meeting attention to meeting preparation) by an independent

### Best Board Practices

Today's best practices according to Carter and Lorsch and echoed in part by Kaen are:

- ◆ Each board should have a majority of independent directors.
- ◆ There should be a leader for the board who is not the CEO... or if the chairman and the CEO (Commander) is the same person, one of the independent directors will be named lead director or presiding director.

- ◆ Independent directors should control the process whereby directors are selected for nomination.
- ◆ Each board should have three core committees: audit, compensation, and corporate governance. (Note: The Sarbanes-Oxley Act requires that independent directors comprise audit committee membership for publicly held firms.)
- ◆ Independent directors should meet periodically alone without the CEO or other inside directors.
- ◆ Boards should be as small as feasible.
- ◆ Boards are expected to carry out certain [minimum] activities:

director has grown to 150 to 250 hours per year.<sup>12</sup> Involved Governance of an integrated Exchange system, therefore, will demand a substantial time commitment from its board members.

## **GOVERNANCE OF AN INTEGRATED EXCHANGE SYSTEM: AN OPPORTUNITY**

Due to the magnitude of an integrated Exchange system with its diverse stakeholders, a different approach to governance is needed. Membership on its Board should not be determined simply by position. Considerable personal time and special competencies are required for quality governance. Based on best practice information, the following are some proposed ideas for debate and deliberation on governance of the integrated Exchange.

At some point, as the Task Force nears completion of its work, the prospective Commander of an integrated Exchange system should be named and provided a period of time, before exercising command, to:

- ◆ Establish and exercise the structure and process of the new central staff;
- ◆ Exercise central information systems needed to direct operations and assume implementation responsibilities from the Task Force plan;
- ◆ Establish external and internal communications;
- ◆ Establish a management control system to measure systems performance;
- ◆ Develop overall strategic priorities.

At some point early in this phase or earlier, membership of the Board of Directors should be identified and an organizing, training, and role definition meeting held.

During the pre-standup phase, the prospective Commander and senior staff should work closely with the Task Force to smooth the acceptance and under-

standing of the implementation plan. During this phase, the prospective Commanding Officer and the Task Force should meet with the Exchange Integration Planning Committee and in turn the Exchange Integration Executive Council to outline a standup strategy, report on the implementation progress, and resolve issues in conflict. After the prospective Commanding Officer informs the Exchange Integration Executive Council that his/her organization is prepared to fulfill its responsibilities, the integrated Exchange command should be commissioned. During this period, the Exchange Integration Executive Council should act as an interim Board of Directors. When the command is established, a new governing structure should come into being. A Board of Directors, to include the Commander, should assume governing responsibilities for the integrated Exchange system.

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### **One Proposed Governance Structure**

The governance structure should be composed of a Board of Directors, the Commander and a COO. The Principal Deputy Under Secretary of Defense for Personnel and Readiness (PDUSD(P&R)) or some other OSD official should be Chairman of the Board. The Commander of the integrated Exchange system should report to the PDUSD(P&R) or the OSD official named as Board Chairman. Initial Board members should be recommended by the Task Force to the Exchange Integration Executive Council and subsequently approved by the Under Secretary of Defense (P&R).

The Board should be an active one, requiring perhaps 150 hours per year or more of personal time. Prior to accepting a position as a Board Director, an individual should make an honest appraisal of his/her ability to set aside enough time to meaningfully discharge

Board responsibilities. The Board is expected to meet seven to eight times a year for at least a full day and may be asked to participate in one two-day retreat per year.

An integrated Exchange system is a \$10 billion global business with a complex variety of business units. It would equal a standing of 177 in the Fortune 500. Customer demographics are not encouraging for future sales growth, and base perimeter competition is intense. The integrated Exchange system model will not be without criticism and growing pains. No significant change is without difficulty. An active Board will be an important asset in meeting these challenges.

Though not required of a government enterprise, the integrated Exchange Board should also pursue the relevant accountability principles set forth in Sarbanes-Oxley. The Board is expected to add value to strategy formulation and performance measurement and help place an integrated Exchange system on the cutting edge of competitive strategies. The Board should be held to the highest standards of governance in exercising its stewardship on behalf of active military and retirees. Positional representation is important, but effective stewardship of this complex enterprise also requires industry expertise and relative independence.

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### **Board Composition**

The Board should be made up of 13 to 15 members to include the Commander and the COO (if these are to be two different positions). The PDUSD(P&R) or another OSD official should be Chairman of the Board assisted by a Vice Chairman who should, among other matters, conduct business Board meetings in the absence of the Chairman. The Vice Chairman should be selected by the Board.

Six directors (or less) should be from within the senior leadership of DOD, chosen from those who are able to devote the required time for governance. One of the DOD directors should be elected by, and represent, the Commander's Service Advisory Board. Six or seven (or perhaps more) members of the Board should be independent directors compensated for their service. A Lead Independent Director (who may also be the Vice Chairman), selected from the independent directors, should be responsible for coordinating the activities of the independent directors. Independent directors should be chosen for their current expertise in areas critical to maintaining an integrated Exchange system at the cutting edge of best industry practices.

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### **Independent Directors**

"The momentum toward independent directors is considerable. In the United States around ten of the average twelve directors on an S&P 500 board are non-executives."<sup>13</sup> A Boston Consulting Group/Harvard Business School global survey of CEOs reported that 61 percent preferred that all boards should have strong independent leadership.<sup>14</sup> Rationale for independent directors centers on the following:

- ◆ They view the enterprise with less internal organizational pressure;
- ◆ They bring special expertise;
- ◆ They can be candid in judging performance, in evaluating the enterprise strategy, and in evaluating financial condition, practices and policies;
- ◆ They can encourage open and candid discussion;
- ◆ They can encourage long-term versus short-term actions to improve stakeholder value;

- ◆ They can provide private counsel to the Commander;
- ◆ They can identify and informally interact with outside experts and other individuals who may help the enterprise.

California personnel pension system administrators (CALPERS 2003) have set out a very strict definition of an independent director.<sup>15</sup> The definition excludes almost anyone who has had even the slightest connection to the business for which he/she is to be director. Former executives, advisers or consultants, significant suppliers, company senior management, and those affiliated with not-for-profit entities that have connections to the business are not to be categorized as independent. The requirement that independent directors have no connections to the business unfortunately excludes many who can offer important insights. Kaen notes that such a strict interpretation may exclude many with important contributions to make.<sup>16</sup> Brontas, with long experience as a corporate lawyer, suggests a valued individual who cannot fully satisfy the "independence" standard can still be made a member of the board as long as that director does not serve on board committees whose entire membership must be independent.<sup>17</sup>

The purpose is to establish a governing Board to shoulder and guide a major organizational change, bring vision and expertise to the business, identify best practices, and otherwise add value to the enterprise.

Independence standards may, therefore, be moderated to allow directors to be nominated who have no significant conflict of interest. If conflict does emerge, directors must bring the issue to the attention of the Board Chair. Upon joining the Board, members with past or present connections to the integrated Exchange

system, however minor, must make this a matter of record with the Board Chair.

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### **Board Member Competencies**

The following skill areas are suggested in selecting independent board members:

- ◆ One director expert in financial reporting and accounting. (Note: Sarbanes-Oxley requires this background for the board audit committee chair.)
- ◆ One director who has run a division, preferably in a global environment, for a mass merchandising company.
- ◆ A present or former CEO from a retail business who understands how to articulate a vision, manage change, and develop strategy.
- ◆ A present or former senior manager expert in supply chain innovations and technology.
- ◆ One director with experience in developing corporate strategy for a retail enterprise.
- ◆ One director with expertise in assessing customer characteristics, demand patterns, and supporting integrative data systems.
- ◆ One director who can reflect the particular needs of each Service.

The composition of the Board should take into account gender and ethnic diversity.

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### **Board Responsibilities**

The Board's responsibilities should include but not be limited to:

- ◆ Approve the strategy developed by management and assess its appropriateness to the expected demographic environment and competitive innovations and practices.
- ◆ Evaluate the performance of the commander and the COO.

- ◆ Oversee the Exchange's management development and succession planning.
- ◆ Evaluate at least once a year their own activities to ensure that the board and its individual members are adding value to the Exchange.
- ◆ Exercise oversight of the process of unification.
- ◆ Recommend to the PDUSD (P&R) the policy for MWR dividends and the reserve for capital development.
- ◆ Approve major investments in facilities and integrative systems.
- ◆ Ensure that the particular needs of each stakeholder are reflected in strategy development and daily operations.
- ◆ The board chairman will periodically summarize to the PDUSD (P&R) the board's findings regarding the system's business performance and quality of service.

### Board Committees

The Board should have an Audit Committee, Governance and Nominating Committee, and Integration Progress Committee. Each committee should be comprised of three members. Each committee may invite an "adjunct member" when special expertise is thought necessary. Adjunct members may be integrated Exchange senior executives, such as the CFO, or outside experts.

See Tables 1, 2, and 3 for Board Committee responsibilities.

**Table 1— The Audit Committee Responsibilities**

1. Exercise oversight of the financial integrity, consistency of financial policy and financial management of the integrated Exchange.
2. Appoint the external auditors and receive their reports.
3. Monitor implementation of external and internal audit recommendations.
4. Be chaired by an independent director, selected by the Board, who has current senior financial or accounting expertise.
5. Report their opinion and findings to the full Board.

**Table 2— The Governance and Nominating Committee Responsibilities**

1. Exercise oversight over the integrated Exchange's strategy, implementation of strategy, and the trends of key Exchange performance and related industry indices.
2. Evaluate the performance of the Commander and the CEO/COO of the integrated Exchange and recommend the tenure of the Commander and the CEO/COO.
3. Be chaired by a Director selected by the Board who should have had experience as a senior executive in an industry comparable to the integrated Exchange system.
4. Recommend for nomination future independent directors.
5. Evaluate the performance of the Board itself.
6. Report its recommendations and observations to the full Board.

**Table 3— The Integration Progress Committee Responsibilities**

1. Exercise oversight of the progress of the merger of all exchanges into an integrated Exchange system.
2. Exercise oversight of the progress made toward best exchange and industry practices.
3. Report recommendations and observations to the full Board.
4. Recommend that the committee be disestablished when unification reaches maturity.

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## **Board Tenure**

DOD members holding Board membership should serve while they are in the DOD position. They may also choose to leave the Board if time demands do not allow their full participation. Initial independent Board members should serve for three years and, upon Board approval, may serve for two additional years. Any independent Board member can be removed by majority vote of the full Board. After the initial three years of the integrated Exchange command's existence, the Board should make provisions to stagger appointments in order to ensure continuity and bring in new expertise and perspectives.

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## **Board Process**

The agenda for each full Board meeting should be set by the Commander and approved by the Board Chairman and the Lead Independent Director. Agenda advice will be sought from the Chairs of the Audit, Governance and Nominating, and Integration Progress committees.

Meetings will be designed to be discussion oriented with focus on major issues confronting the enterprise. Independent directors should be encouraged to hold private meetings apart from full Board deliberations. The Board Chair may choose to allow the Lead Independent Director (Vice Chair) to set the agenda for and chair two or three of the regular Board meetings. Among other issues, every agenda should include a discussion of the business strategy and its implementation. The quorum to conduct business should be 60 percent of Board membership. A member unable to attend a scheduled meeting may delegate his/her vote to another member of the Board. A delegated vote does not count in determining a quorum.

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## **Commander and the Board**

The Commander should report to the PDUSD(P&R). The Commander should have the added responsibility of reporting on integrated Exchange business matters to, and receiving business guidance from, the Board of Directors of which he/she will be a member. The Commander should oversee the development and implementation of the integrated Exchange's major policies and business strategy, measure his/her organization's performance, evaluate the COO's performance, and act as spokesman for the integrated Exchange. The Commander should coordinate with the Board of Directors with regard to meeting dates, agendas, and flow of information necessary for the Board to meet its responsibilities.

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## **Commander and COO Tenure**

The term of the first Commander should be five years subject to satisfactory performance. A term of this length should provide incentive for extended decisional perspective. The first COO should serve a term warranted by his/her performance. COO performance appraisal should be accomplished annually by the Commander and reported to the Governance and Nominating committees of the Board.

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## **Commander's Advisory Board**

The Commander should, prior to the standup of the integrated Exchange command, establish an Exchange Advisory Board. The Advisory Board should include members representing each Service and other stakeholders. Service representatives should be appointed by the Secretaries of each Service. The Advisory Board should represent special needs or concerns of the individual Services and other stakeholders. Members should be briefed

by the Commander on the strategy of the enterprise and on any problems that may affect those whom they represent. The Advisory Board should meet with the Commander four times per year. Proceedings of these meetings should be published and distributed to interested parties and to the Board of Directors. The Advisory Board should elect one of its members to sit on the full Board of Directors. That member should represent issues important to the Advisory Board.

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## **The COO of the Integrated Exchange System**

The COO should report to the Commander and provide management of the day-to-day operations of the integrated Exchange system. He/she should perform such other duties as may be assigned by the Commander. The COO should appraise the performance annually of senior executives and report those evaluations to the Commander. The Commander will summarize these evaluations to the Board's Governance and Nominating Committee as part of her/his assessment of the senior management team.

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## **Corporate Responsibility for Financial Reports**

Section 302 of Sarbanes-Oxley requires that the CEO and CFO of each issuer shall prepare a statement to accompany the audit report to certify the "appropriateness" of the financial statements and disclosures contained in the periodic report and that these financial statements and disclosures fairly present in all material respects the operations and financial condition of the issuer.<sup>18</sup> The Commander and the CFO of the integrated Exchange should complete this certifying statement. The certification links management financial decisions to the external audit report and is a contribution to full disclosure.

## POSTSCRIPT

This paper sets forth one view of a governance concept for an integrated Exchange system drawing from relevant best business practices. Others will hold different views of governance. Board competencies, time commitment, composition, inclusion of independent directors, responsibilities, committees, and the chain of command for an integrated Exchange system are especially fertile areas for debate. The debate is likely to be vigorous. The outcome will importantly shape the long-term success of the Exchange system.

## ENDNOTES

1. Brontas, Paul P. *Boardroom Excellence*, Hale and Dorr LLP, 2003: iv-9.
2. *Ibid.*
3. Carter, Colin B. and Lorsch, Jay W. *Back to the Drawing Board*, Harvard Business School Publishing Corp., 2004: 24-25.
4. Carter and Lorsch: 25-28.
5. Kaen, Fred R. *A Blueprint for Corporate Governance*, Fred R. Kaen, 2003: 3.
6. Carter and Lorsch: 36.
7. Laseter, Timothy M. (2004). "Military Exchange Unification: The Strategic Case for Change," 1-6, <http://www.unifiedexchange.org>.
8. Sarbanes-Oxley Act 2002, Public Law 107-204, 107th Congress.
9. Carter and Lorsch: 16-17.
10. Carter and Lorsch: 144.
11. Kaen: 176.
12. Brontas: 42.
13. Carter and Lorsch: 44.
14. Carter and Lorsch: Figure A-33, p. 220.
15. <http://www.calpers-governance.org/principles/domestic/us/page.13.asp>
16. Kaen: 172.
17. Brontas: 30-31.
18. Sarbanes-Oxley, Section 302.

This series of articles is sponsored by the Unified Exchange Task Force (UETF) to provide new perspectives on the business of military resale. UETF is charged with developing a comprehensive plan to integrate the exchange services into a single organization. More information on the Task Force can be found at [www.unifiedexchange.org](http://www.unifiedexchange.org).